

# Considerations in Developing a Variable Pay Program



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# Agenda

- **Basic Foundations**
- **Types of Variable Programs**
- **Getting Ready**
- **Elements of the Programs**
- **Current Usage**
- **Closing**

## **Variable Pay**

**Variable pay refers to compensation that is received in addition to the base pay. The amount received may be linked directly to individual, team, division and/or organization performance, and is determined (typically) by a variety of measures important to the organization.**

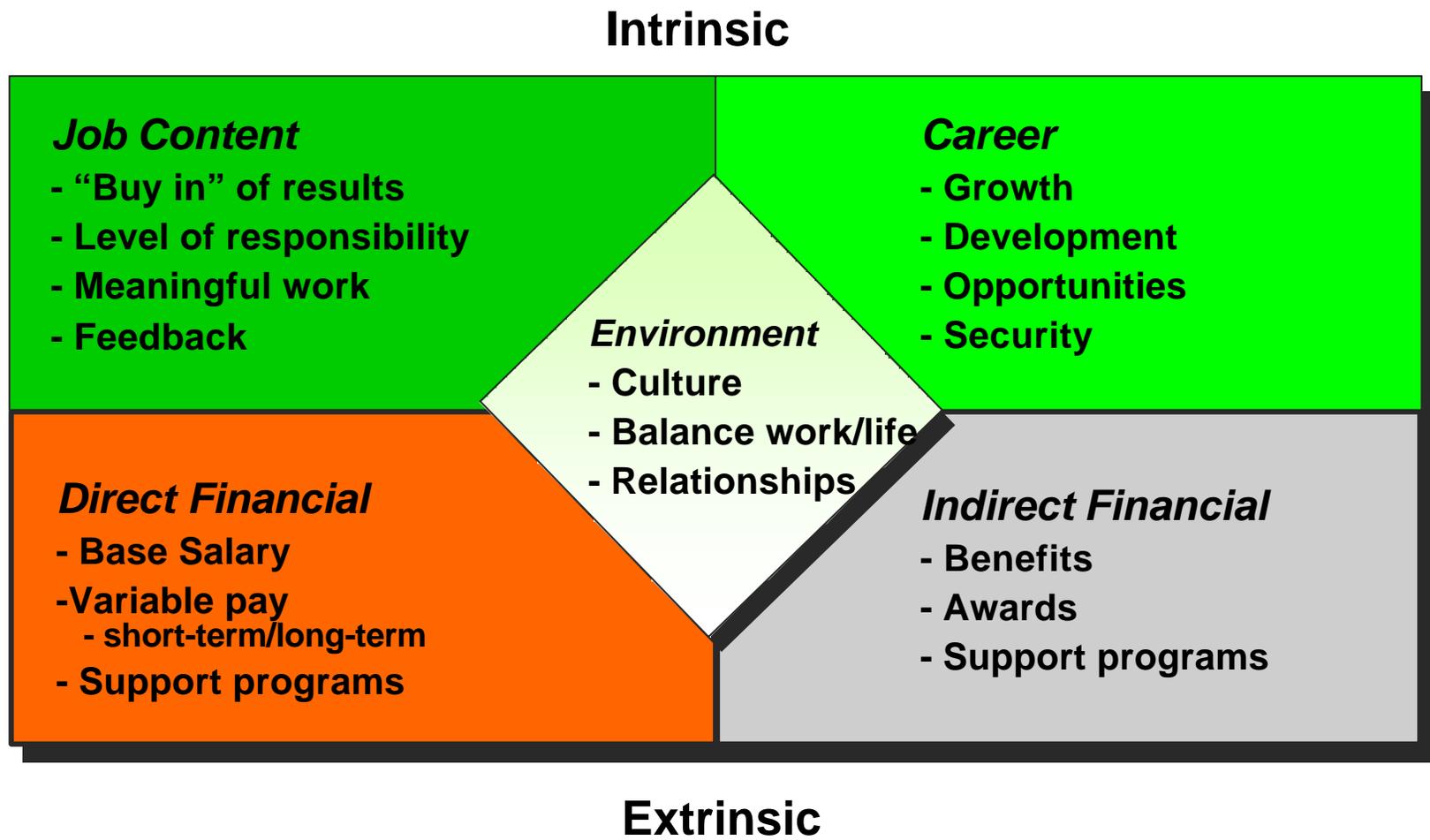
**It may be known in advance (incentive) or as an after the fact reinforcer (bonus).**

**Payment can be made in many forms; cash, stock, time, and even 4T's.**

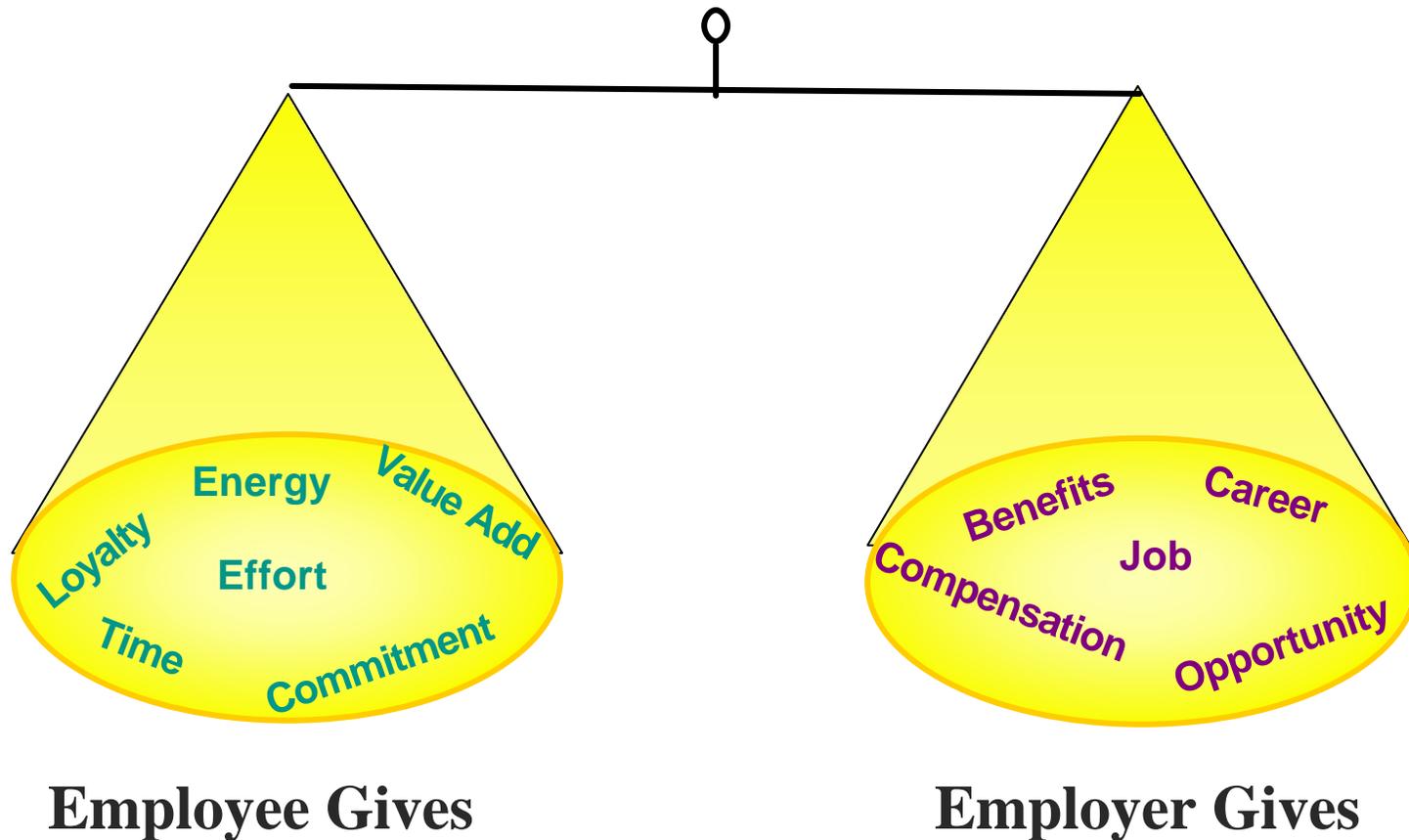
# Why Variable Pay Compensation?

- Reinforces Cultural Change
- Aligns Pay with Results
- Suppresses Entitlement Mentality
- Encourages Employees 'Stakeholdership'
- Communicates Values to Employees
- Focuses Employees' Activities
- Can "Buy" Security

# Variable pay is part of a larger reward strategy



**Value Exchange Theory Requires A Balance - No program proves this more than variable pay!**



# Two Primary Theories

← Reinforcement

- Behaviors occur due to experience in reinforcement and objective measurement of value of past rewards
- Looking back

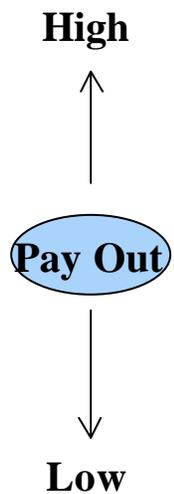
**Bonus only**

Expectancy →

- Adjusts behaviors due to anticipation and subjective weighing of future rewards
- Looking out

**Incentives**

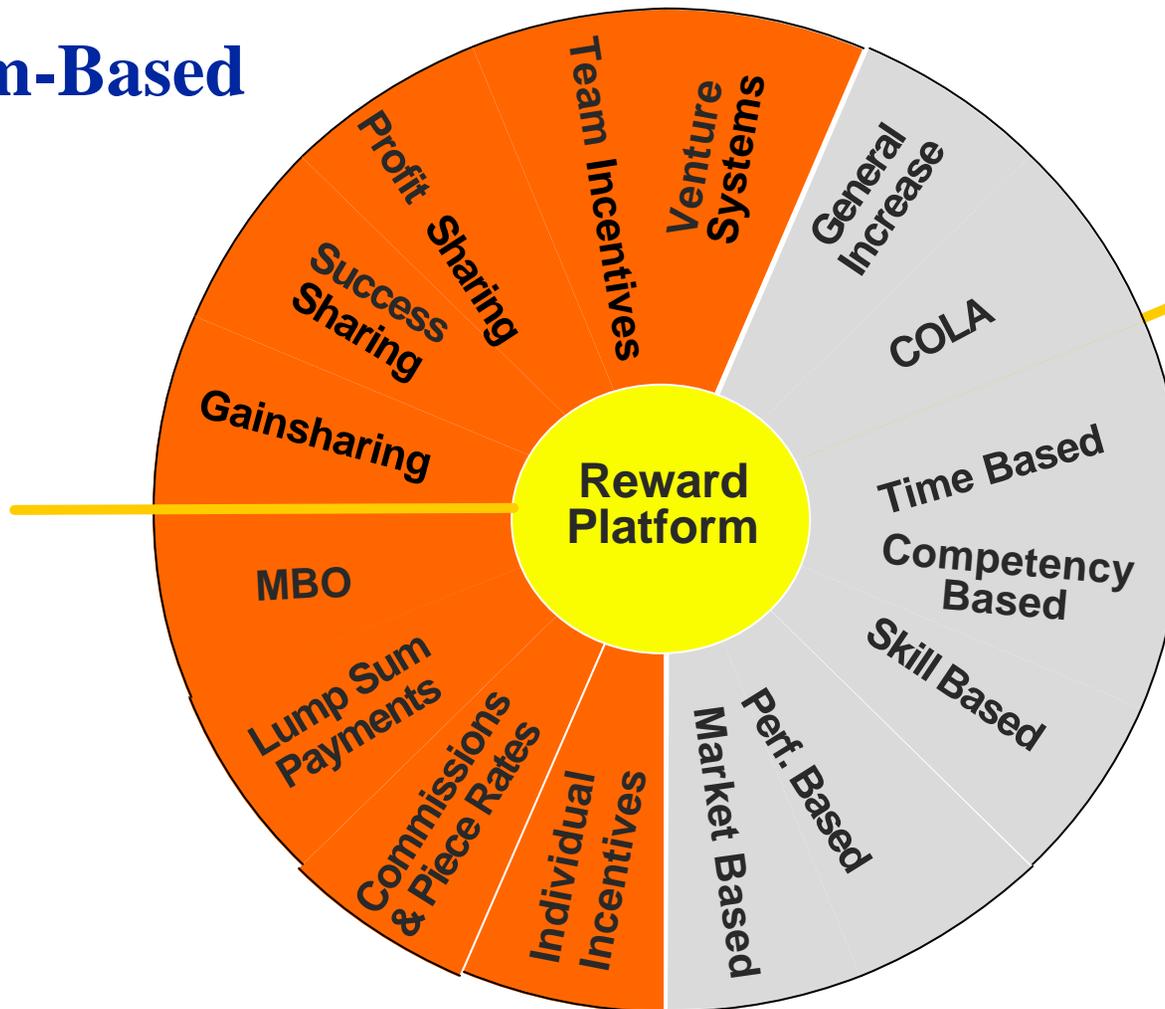
**You have to ask yourself do you really believe this chart?**



<b>Overpaying</b> Who designed this?!	<b>Ideal</b> Worth the investment
<b>Underachieving</b> Something is not working	<b>Unstable</b> Value Exchange Issue

# 'Type' of variable pay

**Team-Based**



▶ Variable Programs

◀ Base Programs

**Individual-Based**



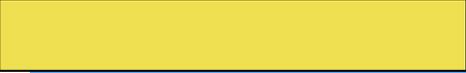
**They can be 'lumped' together**

**Spot Awards - Bonus**

**Calendar Based Incentive**

**Event Based Incentive**

**Long Term Incentive (greater than one year)**

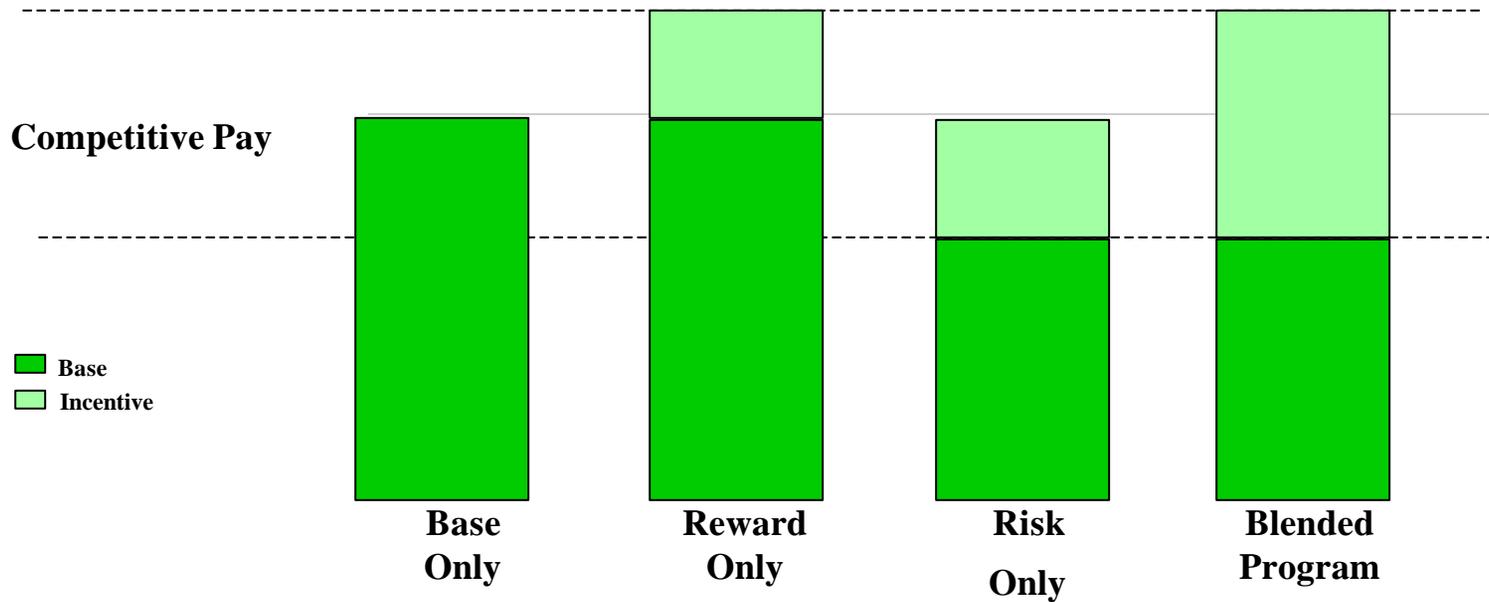


# Strategy of Design



- **“Gain” sharing - Upside only**
- **Risk - Downside only**
- **Balanced risk and reward - Downside risk and upside opportunity**

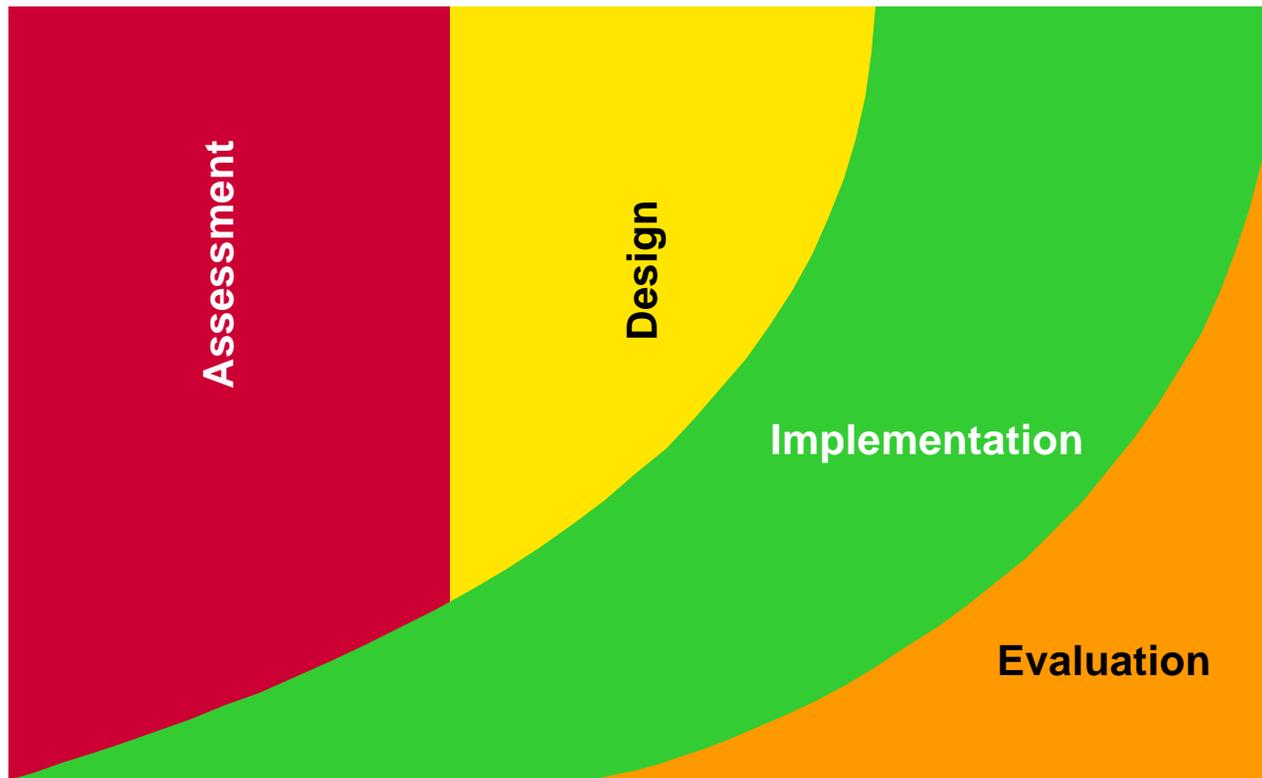
# Strategy of Plan



	<i>Percent pay out to competitive pay</i>			
<b>Above Performance</b>	100%	120%	100%	120%
<b>Target Performance</b>	100%	100%	100%	100%
<b>Below Performance</b>	100%	100%	90%	90%

# Process Overview

Phases



Time Line

# Assessment

- **Why are you moving to a variable plan?**
- **What are the core objectives?**
- **Can the employees impact the objectives?**
- **Is the organization ready for variable pay?**
  - What level of trust is there?
  - What level of communication exists?
  - Can you measure objectives?
- **Who is the champion of the program?**
- **How committed to change are the Sr Leaders?**
- **Is this the right time?**



# **Design Elements**

- 1. Intent**
- 2. Eligibility**
- 3. Participation**
- 4. Performance Criteria-Measurements**
- 5. Goals within Measurements**
- 6. Funding**
- 7. Pay Outs & Timing**
- 8. Benefits Impact**
- 9. Administration**
- 10. Evaluation - Plan Success**

# 1. Intent of Program

Understanding the intent of the plan has two objectives:

1. Makes you think
  2. Communicates to employees
- What is the purpose of the plan?
  - What are we trying to do?

*The plan is designed to motivate and unite key leaders by providing a pay system which allows them to share in the financial success of the organization.*

## 2. Eligibility

- **Who is eligible for the program?**
  - Sr. Leaders
  - Managers
  - Professionals
  - Hourly/Non-exempt
- **Is there a required employment time frame?**
- **Individuals on Leave? Performance?**

### 3. Participation

- Is the plan designed so that all collect or only a portion?
- Do they participate in the same amounts?
- Will differences create barriers to team work?

*Example of a leveled plan*

Employee Level	Salary Linked to Incentive
9	30%
7,8	15%
4-6	10%
1-3	5%

## 4. Performance Criteria

- **What are the measures to be?**
  - Financial, Objectives, Satisfaction, and a million more
- **At what level will we measure?**
  - Organization, Unit, Department, Individual or combo?
- **Can you have different measures at different levels?**

Employee Level	Organization (%)	Unit (%)	Department (%)	Individual (%)
9	40	50	0	10
7,8	40	20	30	10
4-6	40	20	30	10
1-3	40	0	50	10

## **4. Performance Criteria - a few words**

- **Don't have more than 3-5 core measures.**
- **If you say you want team work - then measure the team NOT the individual**
- **If you have sub-measures make sure they are related**
- **Ensure that you can get the information on the measures**
- **Ensure that employees can have some impact on them**

## 5. Metric/Goals within Measures

- **Circuit Breaker**
  - A performance level that turns all measures off.
- **Threshold**
  - The minimum performance level at which you would pay out on a variable pay program.
    - Typically 80-85% of target preference
    - Last years performance
  - Question - can different groups, organizations, have different thresholds?
- **Targeted performance**
  - The performance level that you expect to be achieved and at which level you would pay the targeted variable amount.

## 5. Metric/Goals within Measures

- **Over-target (above plan) Performance**
  - Payments in excess of the targeted payment for performance in excess of the established metric/goal
  - Can you have some measures with opportunity for over achievement and others not?
  - Do you change the 'ramp' with over achievement?
  - Do you have a cap?
- **What if a major change occurs in mid year to change the goals?**



## A few words on the Metrics



### Keep it Smart!

- **S**ignificant but **S**imple
- **M**easurable
- **A**ttainable
- **R**esponsible
- **T**imely

## 6. Funding

- **Where is the \$\$\$\$ to come from to fund the program?**
  - New money? Increase in Performance? Current Compensation?
- **Is a 'pool' created for distribution?**
- **How do you plan to 'get it' in current compensation?**
  - Increase Offset?
  - Cut in current compensation
  - "Cash-flow" movement

## Cash Flow Example

- Current base only = \$100

- Cash Flow”

Base equals = \$90

Day One payment = \$10 (advancing the payment)

Next Day One Base = \$90

Next Day One is based on performance = \$0 to \$20

## 7. Pay Outs

- **When are the measures to be taken?**
  - Quarterly, Annually, On an event?,
- **Are the pay out calculations**
  - Straight line
  - Ramped up
    - Stepped up
    - Interpolated
- **What is the payout?**
  - Cash, Stock, something else?
- **Is it a percentage of salary, or grade? Or is it a set dollar figure?**

## **8 & 9 Benefits, and Administration**

- **Must the employee be employed? When?**
  - At end of measurement or payment date?
- **What about LOA's?**
- **What about Death?**
- **Are new hires or transfers eligible?**
- **Must transfers be in their 'group' plan?**
- **How does the pay out impact:**
  - Benefits? - Pensions, Life Insurance
  - Future increases?

## 10. Plan Evaluation

- How do you know it is working?  
*Set up evaluation criteria in your plan document!*
- When will you evaluate the program?  
*Every day of the year!*
- What if the program is a mess in mid year?  
*Remember many courts see this as a contract!*

## **A few words on implementation**

- **Variable pay is a strong communication tool.**
- **You must consider all the communication needs**
  - The roll out
  - The measures
  - The performance.
- **You should document the entire plan in a plan document.**

# Short-Term Variable Pay: *Usage*

- Median base rate for incentive \$30,000 - 72.8%
- Most effective plans have 3-5 measures
- Most effective plans link to business
  - 66% strong linkage
  - 23% moderate linkage
  - 11% little linkage
- At risk component growing
  - 19% FY95
  - 28% FY97
  - 50% >FY99
  - 82% Planned >FY2001 (but I think some of this is just talk)
- Most plans find it difficult to put \$ on gains
  - 42% can measure impact in \$'s
  - 58% can not measure impact in \$'s

## A few other facts

- Impact on Base Pay (Transition)
  - Addition to current pay 76%
  - Pay replacement 7%
  - Future Increase Replacement 15%
  - “Cash Flow” model 2%
- Distribution to peer members
  - Same Size Awards 76%
  - Different Size Awards 24%
- Distribution amounts
  - Same dollar amount 56%
  - Percent of Base Pay 44%



## **Summary: *Risks***



- **Changes behavior**
- **Outcomes are not always desired**
- **Will impact company culture**
- **Poorly designed programs can be expensive**
- **Loss of trust by employees**
- **Watch out for the non-exempt issues!**

## Basic Rules To Remember

- People want to do the best they possibly can for both social and personal “approval”
- People act in ways that get rewarded and avoid those that don't
- Lastly -

*The Good News is that incentive systems work.*

*The Bad News is that incentive systems work!*